

Covalon Technologies Ltd.

Management's Discussion and Analysis of Financial
Condition and Results of Operations

September 30, 2011

MANAGEMENT'S DISCUSSION & ANALYSIS

For the year ended September 30, 2011

January 27, 2012

The following discussion of Covalon Technologies Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our audited consolidated financial statements for the year ended September 30, 2011. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

The Consolidated Financial Statements and Management's Discussion and Analysis ("MD&A") have been prepared by management, who, when necessary, have made informed judgments and estimates of the outcome of events and transactions, with due consideration given to materiality. Management acknowledges its responsibility for the fairness, integrity, and objectivity of all information provided in the consolidated financial statements and in the MD&A thereof. As a means of fulfilling its responsibility, management relies on the Company's system of internal controls. This system has been established to ensure, within reasonable limits, that assets are safeguarded, transactions are properly recorded and are executed with management's authorization, and that the accounting records provide a solid foundation from which to prepare the Consolidated Financial Statements and the MD&A. The Board of Directors carries out its responsibility for the consolidated financial statements principally through its Audit Committee. This committee meets periodically, reviews the scope of the external audit, the adequacy of the systems of internal control and the appropriateness of financial reporting, and then makes its recommendations to the Board of Directors. Based on those recommendations, the Board approves the Consolidated Financial Statements and the MD&A.

All dollar amounts included in the MD&A are Canadian dollars unless otherwise specified.

Non-GAAP Measures

In this MD&A, we refer to terms that are not specifically defined in the CICA Handbook and do not have any standardized meaning prescribed by GAAP. These non-GAAP measures may not be comparable to similar measures presented by other companies.

Additional Information

Additional information on Covalon, including our information circular and quarterly reports, is available on SEDAR at www.sedar.com and in the investor relations section of our web site at www.covalon.com/Investors.

Forward-looking Statements

This MD&A contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risks & Uncertainties" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Company Overview

Nature of Our Business

Covalon Technologies Ltd. is a unique public medical technologies company that researches, patents, develops and commercializes advanced medical technologies that improve patient outcomes and save lives. Our offices and laboratories are located in Mississauga, Ontario, Canada.

The medical device market in which Covalon is engaged offers tremendous opportunities. Any medical product or wound dressing in contact with the human body has the potential to facilitate an infection or cause other life-threatening complications that can place patients at risk and incur additional hospitalization days and expensive treatment regimes. These issues have forced medical companies to seek advanced technologies, such as those offered by Covalon, which typically command more advantageous reimbursement rates and offer product differentiation.

Covalon has a broad footprint of proprietary technologies, intellectual property, and patents focused on large medical markets that are related to:

- *Advanced Wound Care products for chronic wounds and negative pressure wound therapy;*
- *Sophisticated tissue repair products for advanced wound care dressings, trauma, and surgical applications;*
- *Unique transparent film dressings with antimicrobials embedded in the silicone adhesive;*
- *Cell therapy technology focused on regeneration of damaged tissue;*
- *Medical Coatings;*
- *Superior medical coatings with customized physical properties, drug delivery capabilities and infection control applications;*
- *Infection Control & Drug Delivery;*
- *Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings for medical devices;*
- *Covalon has experience with the delivery of a number of therapeutics and biologics which is applied in both wound dressings and coatings for medical devices to make them therapeutically active;*
- *Innovations for over-the-counter offerings, antimicrobial consumer products and veterinary applications.*

Covalon licenses its technologies and products to some of the largest medical device companies in the world. Covalon also works with niche start-ups to create novel technology to advance their product offerings in the medical device markets. Covalon has worked with over twenty medical companies and our clients include leaders in vascular access devices, device and patient care distributors, wound care products, specialty medical device manufacturers and major contract manufacturers.

These and other major medical companies, in management's opinion, are likely to be impressed with Covalon because of our:

- *Knowledgeable team of medical researchers, scientists and engineers;*
- *Broad footprint of technologies and associated patents and applications;*

- *Extensive experience in commercialization of ideas that lead to marketed products;*
- *Rapid customization of technologies for specific applications with accelerated time-to-market;*
- *Flexibility in structuring licensing and technology transfer arrangements;*
- *Ability to perform low-volume commercial manufacturing or have its high quality products contract-manufactured in high volumes and low cost, if so desired by the client;*
- *Strong balance sheet.*

Once a company partners with Covalon, there is a strong likelihood they will continue to work with us for other new product opportunities and contract renewals.

Clients value our market driven collaborative approach in delivering innovative proprietary technologies. Key stakeholders in each company; from R&D, business development, and finance, to regulatory, sales and marketing work with Covalon's experts on everything from brainstorming on a potential offering, up to turnkey product development and technology transfer. Companies leverage our in-depth knowledge and commercialization success to assist in establishing product specifications, testing of efficacy, microbiology and file preparation for market approvals. Where appropriate, we design a client's product to meet the requirements of the most beneficial billing codes.

We leverage our in-house manufacturing facility to perfect commercialization processes and to manufacture client products in smaller commercial volumes. The relationships that Covalon has with contract manufacturing organizations ("CMO") provide us or our clients with additional resources, flexibility, and expertise for large-scale production, without the burden of substantial committed facilities. As an ISO 13485 quality-systems company, Covalon ensures all technology developments conform to quality guidelines and all transfers of technology are easily integrated into a partner company's processes.

Business Model

Currently, we sell our technologies to medical companies and distributors. These medical companies and distributors license our technologies for incorporating into their own product offerings, which they sell to healthcare providers. Referred to by the industry as an OEM sales model (original equipment manufacturer), this approach assigns the major cost of selling to our customers, who are able to penetrate the market with a large sales force in geographical locations where Covalon does not have staff or offices. Our revenue streams are typically generated from product sales, services, technology licensing fees, and royalties from the sale or commercialization of products.

Most OEM sales models involve a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation and then to market roll-out. This process generally takes twelve to eighteen months – although there are exceptions for both shorter and longer times for the completion of a project. On the other hand, once a company invests time and money in choosing our technology, it is likely to use it for some time to come.

We are confident that as we succeed in signing further new contracts with major medical companies and distributors, Covalon will become a self-sustaining medical research and development company that will continue to discover new and exciting technologies that improve patient outcomes and save lives.

Our Technologies

Covalon's accomplished team of scientists individually are recognized in the medical industry as experts in Customized medical device coatings; Antimicrobial and infection control technologies; Accelerated

tissue healing and regenerative technologies, Advanced drug delivery technologies, and many other areas.

Covalon's staff complement is largely comprised of scientists, engineers and experienced medical technology sales and marketing professionals. Over eighty-five percent hold an advanced academic degree in chemistry, biology or physics and the Company's engineers have decades of collective experience in commercializing and selling innovative technologies.

Together, our technology platforms, wound care products, and consulting services deliver a suite of cost-effective solutions to help our customers achieve product differentiation through improved patient outcomes and help save lives. Covalon's technologies address important healthcare issues such as infection control, medical device biocompatibility, and healthy tissue repair.

Advanced Wound Care

Covalon's expertise in wound care has led to the development of proprietary technologies comprising collagen, antimicrobial silicone adhesive dressings and advanced tissue repair technology.

Collagen:

Covalon's advanced collagen dressing technologies are essentially collagen-based substances that can hold and release a variety of materials, and/or allow materials to pass through the dressing. These dressings begin from a collagen base, which is generally biocompatible with the human body, and enable the release of beneficial materials, such as antimicrobials, into the wound site and/or enhance the removal of undesirable materials, such as wound exudates from the wound. Variations in Covalon's basic formulation will yield different rates of release, duration of release and/or size of particles removed. Covalon's unique collagen construct is ideally designed for wound healing because it provides a scaffold for cellular growth. By combining these characteristics with the many materials that can be added to the dressing, Covalon has a broad range of potential applications for this technology.

Covalon initially developed and received regulatory approval for a suite of advanced collagen-based wound dressings. These wound dressings improve wound healing by removing wound bed enzymes that otherwise slow down the healing process. Certain of the collagen wound dressing formulations contain active silver, which is released into the wound as an antimicrobial agent to further improve the wound healing process. The Company markets and licenses these wound dressings under the brand name ColActive® through a number of independent distributors and under the private labelled brand BIOSTEP™ which is marketed and sold by a large wound care company.

The following Collagen product families have regulatory approval for sale:

Product	Description	Clearance	Since
ColActive®	Collagen Wound Dressing	FDA, Health Canada	2007
ColActive® Ag	Collagen with Silver	FDA, Health Canada	2007
ColActive® Plus	Collagen Wound Dressing	FDA, Health Canada, CE	2007
ColActive® Plus Ag	Collagen with Silver	FDA, Health Canada, Other	2007
CovaClear™ Ag	Collagen Hydrogel with Silver	FDA, Health Canada	2007

We have a number of new and novel wound care technologies under development that combine biocompatible materials with a variety of therapeutics to address specific needs in the wound care market.

The experience that Covalon has gained in developing collagen wound care products is now being leveraged to enter into the high value surgical products market.

Silicone Adhesive Technology:

Covalon has developed the first silicone adhesive with two antimicrobial agents embedded directly in the adhesive. Based on this proprietary technology, Covalon has developed a line of transparent antimicrobial film dressings for the vascular access and surgical wound care markets (IV Clear™ and SurgiClear™, respectively). Health Canada approval has been received for both products, with FDA clearance pending.

IV Clear™ is a unique transparent antimicrobial cover dressing designed to cover and protect infusion therapy sites. Covalon's latest wound care innovation is engineered from a novel transparent polyurethane film which is coated with a patented blend of silicone adhesives, chlorhexidine and silver. It is gentle to the skin, and provides maximum patient comfort. Unlike most other products containing silver, silver discoloration is deterred, ensuring the dressing stays transparent for seven days.

Management believes IV Clear™ dressings offer significant advantages over existing products in the market. IV Clear™ elutes or releases the active antimicrobials directly from the adhesive to the skin continuously for at least seven days, thereby providing maximum protection against direct microbial colonization as well as creating an antimicrobial shield around an IV line entry point. The combination of silver and chlorhexidine provides a much broader spectrum of powerful killing activity than any competitive product currently on the market, and also decreases the likelihood of encouraging resistant organisms.

Management believes the potential for IV Clear™ is great; according to Nursing 2009 more than 7 million central venous access devices (CVADs) and 160 million peripheral I.V. catheters are placed each year in the United States. An average of 2.1 million critical care patients require CVADs, and nearly 250,000 cases of catheter-related blood stream infections (CRBSI) occur among ICU patients. Healthcare-associated infections cost billions of dollars each year. Patients with CRBSI spend more time in the ICU and in the hospital, need more medications and diagnostic studies, have higher catheter removal and reinsertion costs, use more supplies, and need additional healthcare provider visits. One CRBSI can cost \$34,500 to \$56,000.

Covalon developed SurgiClear™, based on the same technology as IVClear™ to address the shortcomings of other surgical site cover dressings in the market. SurgiClear™ is a unique transparent antimicrobial silicone based dressing designed to cover and protect surgical sites. Engineered from a novel transparent polyurethane film coated with a patent-pending blend of silicone adhesives and antimicrobials, SurgiClear™ is gentle to the skin for maximum patient comfort. Its removal will not tear or damage fragile skin, and the novel adhesive film provides excellent tissue contact and infection management. The use of silicone materials on wounds is known to help reduce excessive scarring during the healing process. We expect this product to be adopted for use on surgical site closures such as breast surgery, caesarean sections, facial surgery, vascular surgery and orthopaedic surgery.

The Company believes the potential for SurgiClear™ is significant. According to the US Centre for Disease Control, 45 million surgical procedures were performed in the US in 2011 and approximately 1.5 million surgical site infections occurred at a cost of approximately \$10 billion annually to treat. Many of these procedures require multiple dressing changes until the surgical incision heals.

Genetic Regeneration of Damaged Tissue:

Covalon's intellectual property portfolio includes patents and intellectual property for stem cell engineering utilizing the EPAS1 gene and a proprietary method of introducing the EPAS1 gene into stem cells ("EPAS1"). This acquired technology is thought to enhance the efficacy of delivering stem cells to repair diseased tissue. EPAS1 is believed to be capable of stimulating the growth of new blood vessels through

a process of therapeutic angiogenesis (new blood vessel formation is referred to as “angiogenesis” and/or “vasculogenesis”). The processes are integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as other diseases related to poor blood flow to tissues and organs.

Covalon performed early mouse model experiments with EPAS1 that showed some promise for stimulating the growth of new blood vessels. The Company’s previous CEO, Dr. Frank DiCosmo championed a pre-clinical research program that targeted EPAS1 on heart regeneration in Congestive Heart Failure (“CHF”) patients who previously suffered a myocardial infarction (“MI”) or heart attack. Dr. DiCosmo’s approach was for Covalon to fully fund the research and the Company invested approximately \$1.7 million into a series of pre-clinical studies. The preliminary results of these pre-clinical porcine model experiments did not demonstrate that EPAS1-modified allogeneic (non-donor specific) stem cells improved both perfusion (volume of blood flow) and cardiac function better than either un-modified allogeneic stem cells or no stem cells.

Management believes it would require significant financial investments in further studies to advance the medical application of EPAS1 in human heart regeneration treatments and then bring the perfected technology to the commercial market. While Covalon intends to pursue other potential funding sources, commercialization partners and medical applications of the underlying intellectual property, management has determined that it is not prudent to continue further pre-clinical research studies in the technology, without proper funding.

The Company recorded a non-cash impairment charge of \$1,700,350 in the income statement against the deferred development cost asset during the year ended September 30, 2010.

The Company continues to believe that the underlying intellectual property may have potential for a number of gene therapy applications and intends to continue to investigate other commercialization opportunities related to the underlying patents and intellectual property.

Specialized Medical Device Coatings

Covalon developed a patented coating process for medical devices that enter the body. The Covalon coating technology advantage is in its unique flexibility, as it has broad applicability across many of the large medical device companies’ product lines and divisions. This is advantageous because it allows the investment these companies make to be spread across many divisions and products. In the past, many large device companies had multiple specialized coating technologies to deal with each product application making coatings a costly investment.

Covalon’s coating process applies a biocompatible coating that is permanently bound to medical devices through a method known as covalent bonding. Our coating technology is ideally suited to be a delivery surface for therapeutics such as drugs, antimicrobials, peptides, anti-proliferatives and biologics. The Company has focused on two areas in this market, which include; 1) devices that are designed to enter the body for a limited period of time; and 2) devices that are designed to be implanted in the body forever. Many of these life-saving devices, when left uncoated, can carry a high risk of medical device failure due to biocompatibility issues between a patient and the medical device.

Covalon’s coating process applies a very thin coating on a medical device that will generally be slippery when moistened and can hold and release a variety of antimicrobial or other therapeutic agents to the surrounding tissue while in use. This ensures biocompatibility and improves the functionality and performance of the medical device implant. Our technology has already proven effective on many polymer surfaces, and is currently being tested and evaluated on other materials, including various metals.

These proprietary processes can be modified and enhanced coatings with specific characteristics that meet customer needs which may include lubricity (slippery when wet), antimicrobial activity, hemo-compatibility, bio-compatibility (to prevent tissue encrustation), or controlled release of therapeutics (drug elution).

Covalon has a number of commercialized coating successes that are currently marketed by our clients under private labelled brand names. As well, existing and new clients are continuously evaluating new coating opportunities for existing products that can benefit from our advanced coating technology, including new materials, existing products on the market or new products under development, as exemplified in the list below:

- *Urinary Catheter and IV lines – to prevent infections*
- *Endoscopic implants – to prevent infection*
- *Venous access catheter – to prevent blood clots and infections on the device*
- *Neuro-vascular devices such as shunts and stents – to prevent bio-fouling (attachment of blood and proteins to the device surface) and infections on the device*
- *Cardiac devices – to prevent expensive surgical interventions required to replace the devices due infections on the device*
- *Implantable infusion devices – to prevent blood clots and infections on the device*
- *Surgical wound drain – to prevent infections*
- *Orthopaedic devices – to extend the coatings technology to metals*
- *Breast implants and tissue expanders – to prevent infections*

Infection Control & Drug Delivery

The targeted delivery of therapeutics from the surfaces of medical devices is an emerging segment of the medical device industry known as combination devices. The FDA has even set up a new category for this segment to accommodate the increasing demand for such devices. Covalon's initial focus has been on antimicrobial and device combinations. Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings of medical devices. Our expertise is now being used to develop other unique antimicrobial solutions that target a number of infection control issues. Covalon maintains a fully equipped research and development lab with top research scientists that work at characterizing different combinations of antimicrobial agents that are extensively performance tested in its in-house microbiology lab.

These new antimicrobial combinations allow us to offer customization around customer set specifications. Infection control problems vary for medical devices, consumer products or wound dressings that come into contact with the human body (or animals, in the case of the veterinary market). There is no one set solution for all problems. Some of the key issues addressed by combining antimicrobials are speed at which it works, effectiveness and the duration of its effectiveness, and the species of microbes being targeted.

Covalon's antimicrobial technologies can be used for applications in the following areas: Medical device coatings; Wound care products; Polymer mixes for extrusion; Skin Sanitizers; Surface Sanitizers; Cosmetics; Consumer products; Veterinary applications, and others.

Over the past number of years Covalon has developed expertise in the controlled delivery of antimicrobials that can be applied to other therapeutics. The Company continues to develop promising

customer driven combinations of drugs and medical devices. Covalon assesses new applications for its drug delivery technology and know-how with partners who want to enhance existing products or introduce new solutions into their respective markets.

Patent Portfolio

Covalon's intellectual property strategy actively pursues new patents on our discoveries as they are made. Covalon currently has patents approved or pending in various jurisdictions around the world. A summary of some of our patents are included below:

Patent	Jurisdiction
<i>Method of Making Antimicrobial Polymeric Surfaces</i>	USA, EU, Australia, other jurisdictions patent pending
<i>System and Method For Coating Medical Devices</i>	USA and International patent applications filed
<i>Drug Delivery via Therapeutic Hydrogels</i>	USA, Canada, EU and Australia
<i>Antimicrobial Photo-Stable Coating Composition</i>	USA and International patent applications filed
<i>Non-Adhesive Elastic Gelatine Matrices</i>	USA, EU, Eurasia, Canada and other jurisdictions patent applications filed
<i>EPAS1 Gene Transfer to Improve Cell Therapy</i>	USA, EU, Canada, and International patent applications filed
<i>Hypoxia Inducing Factors and Uses Thereof for Inducing Angiogenesis and Improving Muscular Functions</i>	USA, EU and Canada patent applications filed
<i>Self-Reinforced Membrane</i>	USA patent application filed
<i>Antimicrobial Silicone Wound Dressings</i>	USA patent application filed
<i>Method for treating a surface with a coating comprising a therapeutic agent and device with a treated surface</i>	USA provisional patent application filed

Analysis of Operating and Financial Results

Covalon is in the process of transitioning from solely a research lab to a successful market focused technology business with a broad platform of patented technologies and products. The Company currently uses predominantly an OEM business model to realize value in the marketplace. Our current OEM revenue model based on selling our technologies to large medical companies does not produce consistent revenues on a quarterly basis. Consequently, any one quarter's results are not particularly indicative of the Company's prospects. Most OEM sales models involve a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation and then to market roll-out. This process generally takes twelve to eighteen months – although there are exceptions for both shorter and longer times for the completion of a project. Revenues are typically realized based on the completion of milestones outlined in contractual agreements. The start and finish of projects is dependent on many factors, many of which are outside the control of Covalon.

During fiscal 2011, Management implemented numerous changes to the operations of the Company, including investing an additional \$689,195 in sales and marketing staff and initiatives. The Company hired its first dedicated sales, marketing, clinical support and business development team members during fiscal 2011. As a precursor to new license and revenue agreements, Management committed significant

attention and resources to increasing its credibility with potential customers and establishing relationships with new medical products companies. This included focusing on establishing brand-awareness among medical products companies and the key opinion leader community in 2011 by attending or exhibiting at 10 major medical industry conferences, launching a new corporate web site, and securing scientific publication for certain new products developed by the Company. The focus on expanding the Company's sales funnel has resulted in a significant increase in opportunities with potential customers. As a precursor to entering into license and revenue agreements with Covalon, medical companies will dedicate resources to evaluating Covalon's technology and engage in confidential business discussions with the Company. During fiscal 2011, the Company entered into 60 new confidentiality and sample material transfer agreements to facilitate confidential discussions and evaluation of Covalon's technologies by a variety of potential partners. This compares to 8 confidentiality and sample material transfer agreements entered into in fiscal 2010. As a result, the Company is generating interest in its products and services to a greater extent than in the past. Management anticipates that this activity will lead to increased revenue as the sales cycle results in expansion of the Company's customer base.

During fiscal 2011, the Company ended its exclusive agreement with Smith & Nephew. The Company continues to supply product to Smith and Nephew on a non-exclusive basis. Smith & Nephew informed the Company that it had reduced sales volumes of Covalon's product with certain of their accounts in the United States reimbursement market. Smith & Nephew's reduced business with these accounts has resulted in Smith & Nephew fulfilling orders during the last half of fiscal 2011 from their inventory and accordingly did not place substantial orders for delivery by Covalon during the last 6 months ended September 30, 2011. This resulted in a \$490,512 decline in wound care sales during fiscal 2011, after taking into account sales to new non-exclusive distribution partners.

Management believes that the full potential of the Company's collagen platform had not been realized under the exclusive arrangement with Smith and Nephew and Covalon is now poised to pursue the market for collagen wound care products aggressively, both within the United States and internationally. Moving quickly to take advantage of the opportunity, the Company began to actively seek new distribution partners.

On August 15, 2011, the Company announced a multi-year distribution agreement with a Canadian distributor that will export and distribute Covalon's ColActive® Plus Ag collagen wound care dressings in the Middle East. The first order under the agreement was received and the agreement included purchase commitments for a minimum of \$700,000 in the first year of the agreement with a total minimum purchase commitment of approximately \$11.2 million over five years.

The Company has also begun direct distribution of wound care products to distributors and resellers in the United States.

On September 6, 2011, the Company announced a distribution agreement with a China-based medical device distributor to market Covalon's antimicrobial coated catheters throughout China and Hong Kong. The ten-year license and distribution agreement includes contractual minimum purchase commitments of approximately \$7.7 million which Covalon will receive over the term of the agreement commencing on regulatory approval in China.

On October 13, 2011, the Company announced a multi-year, non-exclusive distribution arrangement with a China-based partner to distribute ColActive® Plus Ag into the Chinese advanced wound care market. The agreement calls for a minimum purchase commitment of \$12 million of ColActive® Plus Ag over the term of the agreement with a minimum commitment of \$500,000 in the first 12 months following regulatory approval in China.

During fiscal 2011, Covalon invested additional capital on research and development and operations compared to the prior fiscal year. During the year, IV Clear™ and SurgiClear™, Covalon's novel

antimicrobial silicone adhesive dressings were cleared for marketing in Canada. The Company invested resources and capital to complete the data required for filing with the FDA in the United States for both products. Initial clinician response has been positive and the Company is actively pursuing opportunities with a number of potential distribution partners.

Financial Highlights for year ended September 30, 2011

Financial highlights are as follows:

- Annual revenue decreased to \$2,588,025 in 2011 compared to \$3,231,067 in the prior year.
- During the year, Smith and Nephew informed the Company that it had reduced orders on certain accounts in the United States reimbursement market. Smith and Nephew's reduced business with these accounts has resulted in Smith and Nephew fulfilling orders from their inventory and accordingly placed significantly less orders for delivery by Covalon during the year.
- Revenue from development services is unpredictable and dependent on the timing of new projects and project budgets of Covalon's large partners. Some of the development projects ended during the year as the resulting products entered the regulatory phase and accordingly development services revenues decreased from the prior year.
- Year-to-date licensing fees revenue increased to \$847,169 compared to \$529,226 in the prior year. The change in licensing fees is primarily due to the full amortization of the remaining balance of the exclusivity fee in the amount of \$421,440 related to the Smith & Nephew contract. The Company ended its exclusive agreement with Smith & Nephew and is currently supplying product to Smith & Nephew on a non-exclusive basis.
- During the year, the Company had five new market-focused products move into the final phases of development and regulatory filing. Substantial resources were required for outside testing to provide data for FDA and other regulatory filings. As a result, research and development expenses increased by \$357,789 in the current year.
- Year-to-date sales and marketing expenses was \$1,065,921 compared to \$376,726 in the prior year. Over the past year management made substantial improvements in the sales and marketing functions of the business in an effort to increase the Company's customer base. During fiscal 2011, Covalon attended or exhibited at 10 industry trade shows. During fiscal 2010, the Company did not exhibit at any tradeshow. More resources were invested on sales and marketing by expanding the sales and business development staff from one person to six people.
- Loss per share for years ended 2011 and 2010 was \$0.05.
- The Company entered into a strategic alliance with Mitec Telecom Inc., a leading designer and manufacturer of mobile wireless components. Mitec invested \$2,496,000 into Covalon, purchasing 8,320,000 shares at \$0.30 per share or approximately 9.9% of Covalon on a post-transaction basis.

Consolidated Statement of Operations and Comprehensive Loss

(Canadian \$)	Three month period ended		Year ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Revenue				
Product Sales				
Advanced wound care	\$ 313,765	\$ 251,733	\$ 887,582	\$ 1,378,094
Specialized medical device coatings	207,177	192,363	853,274	1,323,747
Total Product Sales	520,942	444,096	1,740,856	2,701,841
Licensing fee	51,483	161,382	847,169	529,226
Total Revenue	572,425	605,478	2,588,025	3,231,067
Cost of Sales	338,648	504,297	1,278,928	1,854,582
Gross Profit	233,777	101,181	1,309,097	1,376,485
	40.8%	16.7%	50.6%	42.6%
Operating Expense				
Operations	133,300	97,120	591,530	495,426
Research and development net of recovery of refundable investment tax credit	213,417	81,979	1,092,741	304,791
Sales and Marketing	359,858	77,551	1,065,921	376,726
General and Administrative	740,163	504,029	1,813,125	1,797,606
Operating expense before undemoted items	1,446,738	760,679	4,563,317	2,974,549
Loss before undemoted	(1,212,961)	(659,498)	(3,254,220)	(1,598,064)
Amortization and depreciation	90,744	112,775	360,418	445,759
Loss on disposal of capital asset	-	(7,380)	-	1,910
Write-down of deferred development costs	-	-	-	1,700,350
Settlement Pay	-	-	-	242,178
Interest income	(9,174)	(13,461)	(52,697)	(53,314)
Net Loss	\$ (1,294,531)	\$ (751,432)	\$ (3,561,941)	\$ (3,934,947)
Loss per share	\$ (0.01)	\$ (0.01)	\$ (0.05)	\$ (0.05)

Product and Service Revenue and Gross Profit

Annual total revenue decreased in fiscal 2011 to \$2,588,025 or 19.9% from \$3,231,067 in the prior year. Quarter-to-quarter revenue continues to be inherently unpredictable due to our business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the timing of completed coating and development services milestone in any period.

The Company ended its exclusive arrangement with Smith and Nephew as revenues from Smith and Nephew decreased by approximately 50% over the previous year. The transition to new distribution and expansion of the customer base resulted in some minor improvements for the fourth quarter.

Revenue from specialized medical device coatings also declined primarily as a result of reduced development services.

The products and services revenue mix changed from the comparative period are as follows:

- 60% of revenue in the fourth quarter of 2011 was derived from advanced wound care compared with 57% in the same period of the previous year;
- 40% of products and services revenue in the current period were derived from specialized medical device coatings compared to 43% in the fourth quarter of 2010;

Gross margin as a percentage of total revenue improved for year ended September 30, 2011. It was 50.6%, compared to 42.6% in the comparative period of fiscal 2010. Gross margin is highly influenced by licensing fees, product mix between advanced wound care and specialized medical device coatings; the mix of silver-based and non-silver based collagen dressings sold in the periods; and the amount of funded coating services included in revenue and costs. Management continues to focus on improving gross margins by rationalizing resources and focusing on business opportunities with greater profit potential.

On October 1, 2009, the Company disclosed two product segments, namely, Advanced Wound Care and Specialized Medical Device Coatings. These segments have been disclosed based on the underlying technology of the product.

For the three month period and year ended September 30, 2011, product and services revenue and licensing fees from advanced wound care were \$313,765 and \$1,528,821 respectively, compared to \$361,633 and \$1,817,696 in the same periods of the prior year. Year-to-date gross margin for the year ended September 30, 2011 improved to \$907,623 compared to \$788,614 in the same period of the prior year. The current quarter saw a substantial improvement in gross profit which was \$172,179 or 54.9% of revenue compared to \$108,645 or 30% in the same period of the prior year.

Products and services revenue and licensing fees for the three month period and year ended September 30, 2011 from specialized medical device coatings was \$258,660 and \$1,059,204 respectively compared to \$243,845 and \$1,413,371 in the same periods of the prior year. The decline for the year of \$354,167 reflects the unpredictability of the start of new development projects and the timing of revenue recognition that occurs as milestones are completed.

Gross profit related to our specialized medical device coatings for the year ended September 30, 2011 was \$401,474 or 37.9% of specialized medical device coating revenue compared to \$587,871 or 41.6% in the prior year. The strengthening of the sales and marketing team has resulted in increased customer interest in Covalon's coating platform. Given the long sales cycle in the medical industry, it is difficult to predict when the increase in customer discussions and interest will translate into revenue generating projects.

Licensing Fees

Licensing fees increased to \$847,169 at September 30, 2011 compared to \$529,226 in the same period of the prior year. The increase in licensing fees is primarily due to the Company ending its exclusive arrangement with Smith and Nephew during the year and as a result amortized the remaining balance of the exclusivity fee in the amount of \$421,440.

Interest Income

Interest income on investments of \$52,697 remained relatively constant compared to the previous year. All investments are made in accordance with the Company's audit committee investment guidelines of investing cash of the Company in low-risk interest-bearing instruments.

Operating expenses

(Canadian \$)				
Expenses before depreciation, amortization and interest income	Three months ended		Year ended	
	September 30,		September 30,	
	2011	2010	2011	2010
<u>Operations</u>				
Wages and benefits	\$ 118,439	\$ 74,448	\$ 484,379	\$ 412,132
Consulting fees	8,128	6,022	67,479	16,497
Other	6,733	16,650	39,672	66,797
Total Operations	\$ 133,300	\$ 97,120	\$ 591,530	\$ 495,426
<u>Research and development activities</u>				
Wages and benefits	\$ 140,231	\$ 169,477	\$ 655,192	\$ 673,445
Consulting and Outside Testing	54,995	(111,078)	432,715	(8,297)
Recovery of refundable investment tax credit	-	-	-	(430,161)
Other	18,191	23,580	105,789	69,804
Government grants	-	-	(100,955)	-
Total Research and Development	\$ 213,417	\$ 81,979	\$ 1,092,741	\$ 304,791
<u>Sales and Marketing</u>				
Wages and Benefits	\$ 312,251	\$ 59,029	\$ 858,968	\$ 243,494
Travel	22,359	8,116	109,369	70,599
Investor Relations	1,375	7,345	23,999	35,124
Other	23,873	3,061	73,585	27,509
Total Marketing	\$ 359,858	\$ 77,551	\$ 1,065,921	\$ 376,726
<u>General and administrative</u>				
Wages and Benefits	\$ 173,428	\$ 154,958	\$ 722,301	\$ 517,385
Director's Compensation	79,824	15,441	123,008	210,331
Advisor expense	221,615	496	246,528	180,799
Professional Fees	194,359	71,024	350,884	391,651
Facility	46,137	42,708	174,364	166,336
Foreign exchange (gain) loss	(29,696)	67,204	4,588	44,717
Other	54,496	152,198	191,452	286,387
Total General and Administrative	\$ 740,163	\$ 504,029	\$ 1,813,125	\$ 1,797,606
Total expenses before depreciation, amortization and interest income	\$ 1,446,738	\$ 760,679	\$ 4,563,317	\$ 2,974,549

The Company's rebuilding and realignment around a market focus lead to an increase in expenses as sales activities increased and five new commercial products were readied for market. Total expenses before depreciation, amortization and interest income for the three month period ended September 30, 2011 increased by 90.2% or \$686,059 over the same period of the prior year. This increase is primarily attributable to increases in sales and marketing, research and development and advisor expenditures.

Quarterly and year-to-date net research and development costs of \$213,417 and \$1,092,741 respectively were higher compared to the same periods of the prior year of \$81,979 and \$304,791. The increase resulted mainly because of an increase in consulting and outside fees related to our silicone adhesive dressings and also the non-recurring recovery of refundable investment tax credit of \$430,161 in fiscal 2010. As IVClear™ and SurgiClear™ approach the final phases of regulatory approval substantial outside R&D testing was required.

The Company's focus on increasing sales required investment of resources to expand the sales and marketing team. Accordingly, sales and marketing expenses have increased compared to the prior year.

The Company is party to legal proceedings. Although the result of litigation cannot be predicted with certainty, management is of the opinion that the proceedings have no merit and will not result in a material loss to the Company.

Related Party Transactions

During the year ending September 30, 2011, the Company paid fees to related parties as follows:

- (i) Management fees totaling \$207,492 (2010 – \$377,346) to a corporation controlled by an officer and director. Included in management fees are stock option benefits that have been valued at \$32,492 (2010 – (\$17,720)). The management fees are paid pursuant to a single management agreement, expiring August 31, 2012. The commitment for the 2011 fiscal year is \$175,000.
- (ii) Directors fees included no cash compensation in fiscal 2011. In fiscal 2010, fees of \$23,500 were paid to certain of the independent directors. Stock option benefits that have vested during the period amounted to \$123,008 (2010 – \$186,831).

These transactions are in the normal course of operations and are measured at the amount of consideration established and agreed by the related parties.

Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from Management's best estimate as additional information becomes available in the future. Management believes that the estimates and assumptions upon which the Company relies are reasonable based upon information available at the time these estimates and assumptions are made. Estimates and assumptions may be revised as new information is acquired, and are subject to change. Areas of significant estimates include deferred development costs, stock based compensation and impairment of long lived assets.

Deferred Development Costs

Development costs that meet generally accepted criteria are deferred and amortized from the beginning of commercial production and sales. Deferred development costs for each technology platform are amortized when the product regulatory approval to sell related products is received, on a straight-line basis over the years remaining on the patent.

Stock Based Compensation

Direct awards of stock are based on the price of common stock measured at fair value at the date of grant and the corresponding expense is recognized in the statement of operations.

The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees, and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to

options. The forfeiture rate for stock based compensation is estimated at the date of grant and revised as necessary until the award has vested.

Impairment of Long-Lived Assets

An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value.

Annually, the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is impairment in the recoverable amount.

Summary of Quarterly Results and Financial Position

The quarterly financial information presented below represents eight quarters of operating results and financial position:

(in Canadian \$)	2011 Fourth Quarter	2011 Third Quarter	2011 Second Quarter	2011 First Quarter	2010 Fourth Quarter	2010 Third Quarter	2010 Second Quarter	2010 First Quarter
Revenue (1)	\$ 581,599	\$ 355,630	\$ 1,028,554	\$ 674,939	\$ 618,939	\$ 1,024,047	\$ 837,140	\$ 804,255
Operating loss before amortization	\$ 1,212,961	\$ 1,129,389	\$ 357,352	\$ 554,518	\$ 659,498	\$ 317,306	\$ 282,805	\$ 338,455
Net loss	\$ 1,294,531	\$ 1,207,559	\$ 430,610	\$ 629,241	\$ 751,432	\$ 647,223	\$ 2,029,034	\$ 443,358
Net loss per share	\$ (0.01)	\$ (0.02)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.03)	\$ (0.01)
Cash and cash equivalents	\$ 4,763,152	\$ 2,659,901	\$ 3,431,454	\$ 4,960,874	\$ 5,838,578	\$ 6,431,954	\$ 4,970,623	\$ 5,428,742
Net working capital	\$ 4,456,098	\$ 2,939,202	\$ 4,078,834	\$ 4,556,347	\$ 5,217,531	\$ 5,970,058	\$ 5,760,650	\$ 6,132,019
Current Ratio	3.6	3.8	5.3	4.05	3.9	3.7	5.9	6.4

(1) includes Product Revenue, Licensing Revenue and interest income for comparative purposes to prior quarters

Our quarterly revenue is inherently unpredictable due to our business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the timing of completed coating and development services milestone in any period.

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of our ability to pay short-term obligations. Current assets include cash and cash equivalents, short-term investments, accounts receivable, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities, and the current portion of deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At September 30, 2011, the Company had 3.6 times the current assets needed to pay its current liabilities.

Liquidity & Capital Resources

(Canadian \$)	As at	
	2011	September 30, 2010
Cash and cash equivalents	\$ 4,763,152	\$ 5,838,578
Short-term investments	\$ 500,000	\$ 500,000
Total assets	\$ 9,322,121	\$ 10,319,792
Deferred revenue	\$ 1,103,512	\$ 1,585,048

Highlights

Cash flows as a result of entering into customer contracts will continue to be unpredictable quarter-to-quarter, due to the timing of receipt of upfront payments under new contracts and the timing of receipt of ongoing royalty payments.

During the quarter, the company entered into a strategic alliance with Mitec Telecom Inc., (Mitec) a leading designer and manufacturer of mobile wireless components. Mitec invested \$2,496,000 into Covalon, purchasing 8,320,000 shares at \$0.30 per share.

The Company also made substantial investments in sales and marketing and in R&D for the final phase data collection leading up to the regulatory filing IVClear™ and SurgiClear™ products. For the year ended September 30, 2011, we had a net cash outflow of \$1,075,426 compared to \$198,048 in the same period of the prior year. We anticipate cash flow will improve as a result of the launch of IVClear™ and SurgiClear™ and as new revenue is generated from the launch of new products, and the impact of increased sales activities is felt as new development services projects come on stream and new distributors begin ordering.

On September 30, 2011 cash, cash equivalents, and short-term investments amounted to \$5,263,152. Covalon follows a policy of investing its surplus cash resources in high quality, liquid, short-term deposits. Cash equivalents as of September 30, 2011 had less than three months to maturity and are cashable without penalty. As at September 30, 2011, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. Management believes that the Company has the capital resources and liquidity necessary to meet its current commitments, support its operations, and finance its current growth strategies.

Total assets at September 30, 2011 were \$9,322,121 compared to \$10,319,792 at September 30, 2010. Cash and cash equivalents and short-term investments comprised almost 56% of total assets at September 30, 2011. Of the remaining assets, the Company's accounts receivable and inventory are liquid, with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of capital assets and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue decreased by \$481,536 to \$1,103,512 at September 30, 2011 from the previous year. The decrease in deferred revenue is due to the amortization recorded during the year which includes the remaining balance of the related deferred exclusivity fee related to Smith and Nephew that has been fully amortized into income through licensing fee revenue.

Commitments

Covalon has signed an offer to lease for its premises at 405 Britannia Road East, Mississauga commencing December 1, 2009 and expiring on November 30, 2014. The annual rental payment fiscal 2012 is \$85,264 and increases annually over the term of the lease. The Company has also entered into three operating leases for some of its office equipment. The equipment is leased at a total cost of \$1,711 per month and expires in 2013 and 2014.

The minimum annual lease payments for the next 4 fiscal years are:

2012 Fiscal Year	\$105,796
2013 Fiscal Year	\$108,379
2014 Fiscal Year	\$ 99,142
2015 Fiscal Year	\$ 15,271

Shares Outstanding

	Number of Common Shares	Stated Capital
Balance, September 30, 2009	74,303,915	\$ 29,173,085
Exercise of stock options	587,793	282,231
Balance, September 30, 2010	74,891,708	29,455,316
Issue of common shares - private placement, net	8,320,000	2,456,043
Balance, September 30, 2011	83,211,708	\$ 31,911,359

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At September 30, 2011, 150,000 (2010 – 150,000) shares valued at \$213,875 (2010 - \$213,875) have been released from trust. The remaining balance of 950,000 shares are still being held in trust.

During fiscal 2011, the Company entered into a strategic alliance with Mitec Telecom Inc., (Mitec) a leading designer and manufacturer of mobile wireless components. Mitec invested \$2,496,000 into Covalon, purchasing 8,320,000 shares at \$0.30 per share or approximately 9.9% of Covalon on a post-transaction basis. The related share issuance costs were \$39,957.

Stock Option Plan

The Company has Stock Option Agreements with its employees, directors and consultants, granting options to them exercisable in whole or part. Common shares have been reserved for fully exercisable stock options on the following basis:

	Number of Options	Weighted Average Exercise Price
Balance, September 30, 2009	5,270,673	\$ 0.91
Granted to related parties	1,055,000	\$ 0.29
Granted to employees	2,380,000	\$ 0.20
Exercised	(587,793)	
Expired	(3,019,948)	
Forfeited	(162,932)	
Balance, September 30, 2010	<u>4,935,000</u>	\$ 0.45
Granted to related parties	710,000	\$ 0.20
Granted to consultants	1,405,000	\$ 0.16
Granted to employees	580,000	\$ 0.20
Expired	(100,000)	
Forfeited	<u>(300,000)</u>	
Balance, September 30, 2011	<u>7,230,000</u>	\$ 0.35

During the year ended September 30, 2010, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 2.12%, dividend rate NIL, average volatility – 128% and an average term of 4.75 years. The estimated forfeiture rate was revised during the year from 0% to 6%. This change has been accounted for as a change in estimate and thus a reduction of approximately \$64,000 to stock compensation expense was recorded in the year.

Total value of 2,380,000 options granted to employees during the year ended September 30, 2010 was \$411,362.

Total value of 1,055,000 options granted to related parties during the year ended September 30, 2010 was \$256,708.

587,793 stock options with a value of \$125,894 were exercised for common shares a cash consideration of \$156,337 during the year ended September 30, 2010.

During the year ended September 30, 2010, 3,019,948 options valued at \$1,408,871 expired and 162,932 options with expiry dates of October 15, 2013, March 31, 2013 and March 4, 2014 were forfeited.

As at September 30, 2010, 1,941,209 (Sep 2009 – 3,550,640) options with a weighted average exercise price of \$0.71 (2009 - \$0.93) were available for exercise.

During the year ended September 30, 2011, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 1.8%, dividend rate NIL, average volatility – 140% and an average term of 4.75 years. The estimated forfeiture rate is 6%.

Total value of 710,000 options granted to related parties during the year ended September 30, 2011 was \$122,262.

Total value of 1,405,000 options granted to consultants during the year ended September 30, 2011 was \$192,141.

Total value of 580,000 options granted to employees during the year ended September 30, 2011 was \$99,876.

During the year ended September 30, 2011, 100,000 options valued at \$34,090 expired and 300,000 options with expiry dates of October 15, 2013, December 11, 2014 and September 2, 2015 were forfeited.

As at September 30, 2011, 4,526,649 (Sep 2010 – 1,941,209) options with a weighted average exercise price of \$0.44 (2010 - \$0.71) were available for exercise.

Sources and Uses of Cash

	Three month period ended September 30,		Year ended September 30,	
	2011	2010	2011	2010
Cash Provided By (Used In)				
Operating Activities				
Cash used in operating activities before change in non-cash working capital	\$ (908,629)	\$ (594,107)	\$ (2,661,583)	\$ (1,369,283)
Change in non-cash working capital	593,635	(2,231)	(662,796)	1,311,082
	\$ (314,994)	\$ (596,338)	\$ (3,324,379)	\$ (58,201)
Investing Activities				
Purchase of capital assets	\$ (17,525)	\$ 7,379	\$ (48,982)	\$ (25,589)
Expenditure on deferred development cost	-	-	-	(162,604)
Purchase of other assets	(34,947)	(31,903)	(169,096)	(98,046)
	\$ (52,472)	\$ (24,524)	\$ (218,078)	\$ (286,239)
Financing Activities				
Net proceeds on issuance of share capital	\$ 2,456,043	\$ 40,000	\$ 2,456,043	\$ 156,337
Foreign exchange gain (loss) on cash held	\$ 14,674	\$ (12,512)	\$ 10,988	\$ (9,945)
Increase (decrease) in cash and cash equivalents	\$ 2,103,251	\$ (593,374)	\$ (1,075,426)	\$ (198,048)

Operating Activities

In 2011 substantial resources were invested in realigning the operations of the company to be market focused. Cash used in operating activities for the year ended September 30, 2011 was \$3,324,379 compared to \$58,201 in the same period of the prior year. The increase in cash outflow was primarily due to the operating loss resulting from the increases in sales and marketing investments and the late stage R&D expenditures required to complete the data for the regulatory filing of IV Clear™ and SurgiClear™ products.

Investing Activities

Expenditures on other costs relates to patents and trademarks.

Financing Activities

On August 23, 2011, the Company entered into a strategic alliance agreement with Mitec Telecom Inc., (Mitec) a leading designer and manufacturer of mobile wireless components. As part of the strategic alliance, Mitec invested \$2,496,000 into Covalon through a private placement, purchasing 8,320,000 shares at \$0.30 per share or approximately 9.9% of Covalon on a post-transaction basis. The total number of shares issued and outstanding following the transaction was 83,211,708.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Financial Instruments

Unless otherwise noted, it is Management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

Short term investments consists of Ontario Savings Bonds (step up interest rates of 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.

All of the Company's cash is maintained by two of the major financial institutions.

The Company has not entered into any futures or forward contracts, or other derivative instruments as at the date of this MD&A.

Subsequent Event

There were no subsequent events.

Risks and Uncertainties

An investment in the securities of the Company is speculative due to the proposed nature of the Company's business and the fact that Covalon Technologies Ltd. has not yet achieved an annual profit. Consequently, an investment in the Company is subject to certain risks and investors should not invest in securities of the Company unless they can afford to lose their entire investment. In addition to the factors disclosed elsewhere in this MD&A, investors should consider the following risk factors in assessing the investment merits of such securities.

Medical Device and Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company.

Without limiting the foregoing, the following risks are discussed in more detail:

Covalon has a history of net losses and may not achieve or maintain profitability.

Covalon has not yet achieved profitability and there is no guarantee that Covalon will be able to achieve profitability in the future. Covalon has never paid a dividend on its common shares and does not expect to do so in the foreseeable future. Covalon's business and prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets such as healthcare.

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least fiscal 2012. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be on acceptable terms.

Any failure to obtain or protect intellectual property could adversely affect Covalon.

Covalon's success depends, in part, on its ability to obtain patents, or licenses to patents, maintain trade secret protection, and enforce its rights against others. Covalon has filed and is actively pursuing patent applications in Canada, the United States and other jurisdictions. Covalon may not be able to obtain patent protection for key elements of its technology.

There can be no assurance that:

- patent applications will result in the issuance of patents;
- additional proprietary products developed will be suitably protected from infringement;
- patents issued will provide adequate protection or any competitive advantages;
- patents will not be successfully challenged by any third parties; and
- patents of others will not impede Covalon's ability to commercialize its technology.

Covalon may need to obtain licenses for the development of its products. Licenses may not be available on satisfactory terms or at all. If available, these licenses may obligate Covalon to exercise diligence in bringing its technology to market and may obligate it to make minimum guarantee or milestone payments. These diligence and milestone payments may be costly and could seriously harm Covalon's business. Covalon may also be obligated to make royalty payments on the sales, if any, of products resulting from licensed technology and may be responsible for the costs of filing and prosecuting patent applications. These costs could affect Covalon's results of operations and decrease its earnings.

Covalon's intellectual property includes trade secrets and know-how that may not be protected by patents. There can be no assurance that Covalon will be able to protect its trade secrets. To help protect its rights, Covalon requires employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not adequately protect Covalon's trade secrets, know-how, or other proprietary information in the event of any unauthorized use or disclosure.

Covalon's development programs and products subject it to the risk of product liability claims for which Covalon may not be able to obtain adequate insurance coverage.

Human therapeutic products and medical devices involve the risk of product liability claims and associated adverse publicity. Covalon's principal risks relate to the sales of its products and currently their use in clinical trials. Claims may be made by consumers, healthcare providers, third party strategic collaborators or others selling Covalon's products. There can be no assurance that Covalon will be able

to obtain or maintain sufficient and affordable insurance coverage for any of these claims. Without sufficient coverage, any claim, any threat of such a claim or any product withdrawal could seriously harm Covalon's business.

Covalon may incur substantial costs as a result of litigation or other proceedings relating to patent and other intellectual property rights.

Covalon's future success and competitive position depends in part on its ability to obtain and maintain certain proprietary intellectual property rights used in its principal products. Any such success may be achieved in part by prosecuting claims against others who Covalon believes are infringing its rights and by defending claims of intellectual property infringement brought by its competitors and others. Covalon's involvement in intellectual property litigation could result in significant expense, adversely affecting the development of product candidates or sales of the challenged product or intellectual property and diverting the efforts of its technical and management personnel, whether or not such litigation is resolved in its favour. Some of Covalon's competitors may be able to sustain the costs of complex patent litigation more effectively than it can because they have substantially greater resources. Uncertainties resulting from the initiation and continuation of any litigation could affect Covalon's ability to continue its operations.

In the event of an adverse outcome as a defendant in any such litigation, Covalon may, among other things, be required to:

- pay substantial damages;
- cease the development, manufacture, use or sale of product candidates or products that infringe upon the intellectual property of others;
- expend significant resources to design around a patent or to develop or acquire non-infringing intellectual property;
- discontinue processes incorporating infringing technology;
- obtain licenses to the infringed intellectual property.

If third-parties file patent applications, or are issued patents claiming technology also claimed by Covalon in pending applications, Covalon may be required to participate in interference proceedings with the U.S. Patent and Trademark Office, or other proceedings outside the United States, including oppositions, to determine priority of invention or patentability, which could result in substantial cost to Covalon even if the eventual outcome were favourable.

Covalon or its clients must receive regulatory approval for each of Covalon's product candidates before they can be sold commercially in North America or internationally, which can take significant time and be very costly.

The development, manufacture and sale of medical devices and human therapeutic products in Canada, the United States and internationally is governed by a variety of statutes and regulations.

These laws require, among other things:

- approval of manufacturing facilities and practices;
- adequate and well-controlled research and testing of products in pre-clinical and clinical trials;

- review and approval of submissions containing manufacturing, pre-clinical and/or clinical data in order to obtain marketing approval based on establishing the safety and efficacy of the product for each use sought, including adherence to good manufacturing practices during production and storage;
- control of marketing activities, including advertising and labelling.

Some product candidates currently under development by Covalon will require significant development, pre-clinical and clinical testing, pre-market review and approval, and investment of significant funds prior to their commercialization. The process of completing clinical testing and obtaining such approvals (if required) is likely to take many years and require the expenditure of substantial resources, and Covalon does not know whether any clinical studies by it will be successful, that regulatory approvals will be received, or that regulatory approvals will be obtained in a timely manner. Despite the time and resources expended by Covalon, regulatory approval is never guaranteed.

Even if some of Covalon's products and manufacturing facilities receive regulatory approval, those products and facilities may still face subsequent regulatory difficulties.

If Covalon receives regulatory approval to sell any of its products, regulatory agencies will limit the approval to certain diseases, conditions, or categories of patients who can use them. In addition, regulatory agencies subject a marketed product, its manufacturer, and the manufacturer's facilities to ongoing regulatory requirements. Regulatory agencies may also require expensive post-approval studies. Any adverse effects associated with Covalon's products must also be reported to regulatory authorities. If new data are developed, previously unknown adverse experiences with a product occur, deficiencies in Covalon's manufacturing and laboratory facilities are discovered, or it fails to comply with applicable post-market regulatory requirements, a regulatory agency may impose restrictions on that product or on Covalon including the requirement to withdraw the product from the market, close the facility, suspend manufacturing, change the product's label or pay substantial fines.

Covalon's success is partly dependent on its partners' success and the relationship with partners is governed by contracts.

Covalon is reliant on partners to execute certain key business processes. If its partners do not perform to Covalon's expectations, Covalon may be unable to enforce a change due to contractual terms. This may significantly impact Covalon's ability to generate revenues and profits.

Examples of such issues include:

- Manufacturing may be prioritized other than as Covalon's customers desires;
- Production quality measures may not be achieved;
- Sales expectations are not achieved;
- New products are not launched expeditiously.

If Covalon fails to hire and retain key management, scientific and technical personnel, it may be unable to successfully implement its business plan.

Covalon is highly dependent on its senior management and its scientific and technical personnel for their domain knowledge and technical expertise. The competition for qualified personnel in the healthcare field is intense, and Covalon relies heavily on its ability to attract and retain qualified managerial, scientific, and technical personnel. Covalon's ability to manage growth effectively will require continued implementation and improvement of its management systems and the ability to recruit and train new employees. Covalon may not be able to successfully attract and retain skilled and experienced personnel, which could harm its ability to develop product candidates and generate revenues.

Accounting Policies

International Financial Reporting Standards (IFRS)

Background, project structure and project progress

In March 2006, the CICA released its plan to adopt International Financial Reporting Standards. After a five year transitional period, at the end of 2011, Canadian GAAP will cease to exist as a separate basis of financial reporting for public companies. The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board (“IASB”) for the year ended September 30, 2012, with comparative information.

Preliminary Impact Assessment

The Company has completed a diagnostic study of the conversion of its consolidated financial statements to IFRS, with the assistance of external consultants. The study identified the principal differences between the Company’s records using existing Canadian GAAP and IFRS standards.

The results of this assessment identified:

- Preliminary analysis of all Canadian GAAP to IFRS differences and IFRS 1 elections and resulting prioritization of high, medium and low impact areas of focus for the Company based on potential impact;
- Preliminary resource requirements;
- A preliminary IFRS Transition Plan (details outlined below).

IFRS Transition Plan

During the year, the Company established a formal IFRS Transition Plan. This plan included:

- An established project structure and governance practices;
- Detailed timetable with milestones and deliverables;
- Identification and allocation of resources (combination of internal and external);
- Development and execution of a training program;
- Detailed analysis of all Canadian GAAP to IFRS differences;
- Detailed analysis and selection of all IFRS 1 elections;
- Assessment of impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements.

The Company has completed the detailed assessment of all standards that affect the transition.

The Company is in the process of completing the solutions development and construction of full financial statements. Specifically, the items identified are being analysed and any differences quantified.

Potential accounting changes as a result of transition to IFRS

The Company has implemented a detailed review of the potential impact of International Financial Reporting Standards, IFRS, on its accounting policies. Outlined below is a very brief summary of select IFRS that may impact the Company, their differences from Canadian Generally Accepted Accounting Principles ("GAAP") and their potential impact. Based on the impact analysis performed with the assistance of the external consultants, the Company has determined what IFRS 1 exemptions to elect. The list below is not comprehensive and does not include all of the differences from GAAP for the standards noted. Also, the list does not include all the standards that may require changes for the transition to IFRS. Some of the standards not presented below could have a significant impact on the Company's consolidated financial statements.

Revenue Recognition – The Company has contracts which generate revenue from licensing fees. Many of these contracts provide upfront payments and under GAAP have been deferred over the life of the contract. Each contract must be reviewed to ensure that the accounting is appropriate under IFRS to determine whether any differences in timing or amount of revenue recognized exist. IFRS 1 does not contain any special exemptions for revenue for first-time adoption. All accounting policies related to revenue have been assessed against the appropriate standard including IAS 18, Revenue for compliance. The Company does not expect any material differences under IFRS.

Stock-based Compensation – The Company intends to use the IFRS 1 exemption to prevent full retrospective restatement of stock options under IFRS. However, retrospective restatement will still be required for any outstanding equity instruments that are unvested and liabilities that have not been settled prior to the date of transition to IFRS.

Under IFRS 2 *Share-based payments*, stock options with graded vesting must be accounted for as separate awards. In addition, forfeitures must be estimated when the stock options are issued. The Company has completed its review of all stock options and does not expect any material differences under IFRS.

Foreign Exchange Translation - The Company sells products to customers in U.S. dollars and purchases some services and raw materials from suppliers invoiced in U.S. dollars. All labour costs are denominated and settled in Canadian dollars. An analysis has been completed and the Company has determined that there will be no change of functional currency under IFRS.

Property, Plant & Equipment (PP&E) – Analysis of all material PP&E accounts is required to ensure that any components with different useful lives are identified and amortized appropriately. Net book values as at the date of transition will be reviewed to ensure that any material components are identified. The Company has reviewed the componentization of PP&E and have found no material differences.

Long Lived Assets – Under IFRS, there is a requirement to test for impairment using discounted cash flows. Under CGAAP, the requirement is to test for impairment using undiscounted cash flows. This could potentially result in an impairment on transition to IFRS. Management has reviewed and determined that there will be no material difference under IFRS.

Presentation and Disclosure – IFRS requires significantly more disclosure than GAAP for certain standards. In some cases, IFRS also requires different presentation on the balance sheet and income statement.

After review of the standards noted above and other differences from GAAP, Covalon does not expect any significant impact of IFRS on its financial statements. However, the Company continues to reassess its evaluations and accounting policy choices and has the ability to adjust or modify conclusions up to the release of our first IFRS statements.

We have completed our analysis of IFRS issues including evaluation of any IFRS 1 exemptions. The project is now in the process of documenting accounting policies under IFRS, creating additional note

disclosures and developing a full set of IFRS statements. Note that consistent with many other entities transitioning to IFRS the Company will revisit its evaluations and accounting policy choices up to and including the date of the release of its first IFRS statements.

The IASB completed several projects in 2011. We originally anticipated that these may significantly impact the transition to IFRS and our financial statements. We have monitored releases of new standards and have opted against early adopting, therefore there will be no impact for the first IFRS financial statements. We continue to monitor the IASB's progress on future projects and their impact on our ongoing IFRS reporting.

Impact on Information Systems and Technology

It is anticipated that the adoption of IFRS will have some impact on information systems requirements. The main drivers for systems changes include:

- Additional information required as a result of enhanced note disclosures;
- Tracking of IFRS to GAAP differences during the transition;
- Tracking sufficient level of details within the accounting records to allow management to maintain adherence with IFRS going forward.

Management believes that it has the necessary tools and resources required to ensure that the above information is captured appropriately.

Impact on Reporting and Internal Controls

In accordance with Covalon's approach to certification of internal controls required under Canadian Securities Administrators' National Instrument 52-109, all entity-level, information technology, disclosure and business process controls will require updating and testing to reflect changes arising from Covalon's conversion to IFRS. Where material changes are identified, these changes will be mapped and tested to ensure that no material control deficiencies exist as a result of the Corporation's conversion to IFRS.

Impact on Business

The transition to IFRS may have an impact on the Company's business practices. The Company will consider the contractual implications of IFRS on any new licensing or other arrangements.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Effective as of December 15, 2008, the Ontario Securities Commission approved the revised *National Instruments 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109"). The revised NI 52-109 extends the exemption for venture issuers from certifications relating to the establishment and maintenance of disclosure controls and procedures ("DC&P) and internal controls over financial reporting ("ICFR"), as defined in NI 52-109. Additional risks to the quality, reliability, transparency, and timeliness of the Company's interim and annual filings may result from the inherent limitations on management's ability to design and implement on a cost effective basis DC&P and ICFR. The Company recognizes the importance of DC&P and ICFR, and will endeavour to have sufficient controls in place to ensure financial statements are materially correct and sufficiently disclosed.

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of September 30, 2011, the Company's management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision,

and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the DC&P, the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's DC&P are effective in providing reasonable assurance that material information relating to the Company is made known to management. Changes and new controls are evaluated and implemented as required to provide greater business control.

The design of ICFR within the Company is management's responsibility to provide reasonable assurance that the reliability of financial reporting and that the preparation of financial statements for external purposes follow Canadian generally accepted accounting principles.